BNZ Weekly Overview

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Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

No Rate Change No Surprise

The Reserve Bank this morning undertook their regular review of the official cash rate and surprised no-one with their decision to leave it unchanged at the 2.5% level it was taken down to early in December. The rate peaked at 3.5% in July 2014 having been lifted from 2.5% in March. The subsequent 1% reduction last year came about partly because the pace of economic growth turned out to be less than they were expecting, but mainly because the rate of inflation has consistently undershot their expectations.

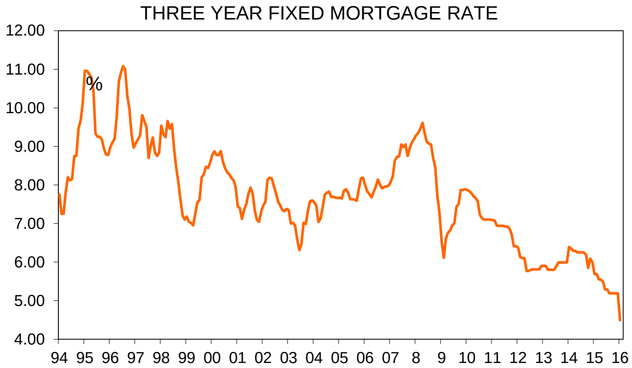
For instance, in the Monetary Policy Statement of March 2014 the Reserve Bank predicted that inflation for calendar 2014 would be 1.9% and for 2015 it would be 2.1%. The actual rate for 2014 was only 0.8%. In March 2015 their forecast for 2015 inflation had been slashed to only 0.4%. As we learnt last week the actual outcome was just 0.1%. That is a full 2% lower than the March 2014 forecast.

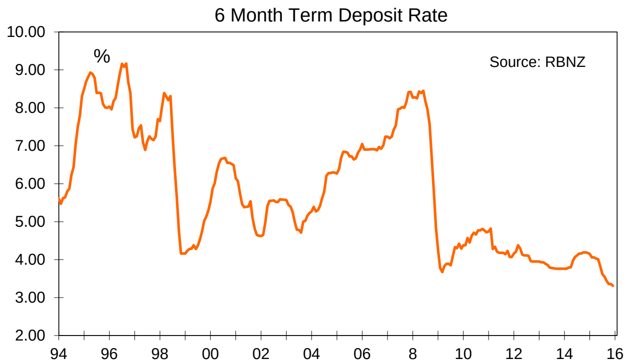
As previously discussed here, post-GFC the links between growth and inflation have been shattered in many ways, along with growth forecasts themselves almost always being too high. Growth is not quite leading to the sort of jobs growth which would have happened pre-GFC. More importantly, jobs growth is not leading to wages growth which would have happened pre-GFC. Wages growth is also not leading to inflation as would previously have happened and a key reason for that is that businesses can no longer easily put their prices up to recoup wage costs.

The cost to consumers of searching for alternative, cheaper, goods and services has been slashed by technology changes and retailer margins have been squeezed – which partly explains why so many chains are going under. In addition energy prices have tumbled courtesy of surging oil supply and demand not growing as previously expected.

Will this all change in the very near future and inflation suddenly jump back up again? That does not seem likely and that is a key reason why although we see good NZ growth the next two years of 2.4% each year, we don't think the Reserve Bank will raise interest rates for a potentially long time. But will they cut them? The markets have priced in a cut as early as March and this cannot be ruled out. But we feel the Reserve Bank will be wary of stimulating the housing market too much, core inflation measures are not as low as the 0.1% headline rate, and it is good to have a 2.5% buffer in case the world economy tips over anew.

Still, as noted here now for six years, forecasts of interest rates have proven consistently wrong for a long time now. So try to spread your risk by taking a mix of floating and fixed rates. These two graphs show the good and the bad for borrowers and savers respectively.

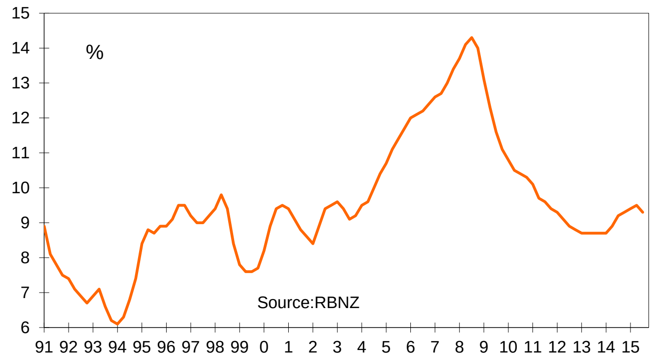




Housing

The annual Demographia Report was issued this week and unsurprisingly it showed Auckland as one of the least affordable cities in the world to live in based upon a comparison of average house prices with average incomes. The usual hand-wringing has occurred, young home buyers have been interviewed, and politicians have either said they are doing something about it, or criticised other politicians for not doing something about it. Enjoy reading all such material if you like, but don't forget the fundamentals contributing to the issue which will not change for decades. Probably not ever.

- Low interest rates making it cheaper to service larger mortgages to buy initially larger houses, then after a few years the same house as you would have bought when interest rates were higher. We discount lower interest rates into prices we are willing to pay. Current debt servicing costs nationwide at 9.3% of disposable household income are in fact below the quarter century average of 9.5%.



- Lack of readily buildable land in Auckland either because it is too far away and there is not enough money for a fast transit transport system, or people holding the land see best value long-term in holding it rather than developing it, or because it is flooded – by two large harbours.
- High construction costs in New Zealand as most houses are one-offs and not cookie-cutter properties which we snobbishly turn our noses up at.
- Rapid population growth in Auckland as people seek to live and work in a large agglomeration delivering high interaction with other people rather than staying in the tourism and farming-focussed regions even if working remotely is a possibility. Auckland's population grew 2.8% in the year to June 2015 and by 14.3% from 2006. Rates for the rest of New Zealand were 1.4% and 7.6% respectively. People are voting with their feet on where they want to be and it isn't in the regions for a growing proportion of them even though the lifestyle available in the regions is fantastic. Imagine what would happen to Auckland versus regional house prices if a public transport drone pod could take you from your work in Auckland CBD to Mokau in 30 minutes!

Some people are of the opinion that you can greatly improve the affordability problem in Auckland by reducing immigration. To help you understand why that is not a realistic contributor to the "solution" consider these numbers.

On average in the past 20 years we have enjoyed a net migration gain of 10,000 people per annum. The last time we were at that average was July 2013. The total is now almost 64,000. What has caused the change over the near two and a half year period ending in November 2015? The number of people leaving New Zealand on a permanent or long-term basis has fallen by almost 22,000 from 79,000 to 57,000. This then explains 40% of the 54,000 net migration change since July 2013 (64,000 less 10,000).

Increased inflows account for the remaining 32,000 part of the 54,000 change. More Kiwis coming back and Aussies waltzing in add up to 6,500. More students studying long-term add up to 13,000. Visitors coming in for longer than a one year jaunt around our lands add up to 1,129. That leaves just under 11,000 to explain. 9,000 of these people have come here for work – probably either to work on dairy farms down south which Kiwis don't want to work on, or to help rebuild Christchurch because of our well known shortage of builders.

That leaves just under 2,000 people to explain. 124 are classified as “Other”, and the other 1,519 are here because they have been granted residence.

So, if you want to try and influence the housing market by cutting back migration-driven population growth you must either force people already here to leave, stop Kiwis and Aussies coming here, prevent people arriving to build the houses we need, or curtail growth in the lucrative foreign student industry. You could of course cut back on residency visas, but given that only 13,8989 people came in on them in the year to November, you’d not really much change the net migration flows.

Controlling migration to influence population growth is not an option for New Zealand because unlike some other countries, our migration flows are not driven by migrants. They are you and I leaving or coming back, workers specifically sought by businesses, students, and a few Aussies. And cutting immigration would be biting off our nose to spite our face because we need the ideas, the vibrancy, the desire to contribute, the connections, and the open thinking embraced by people shifting half-way around the planet if we are to move our economy toward reduced dependence upon commodity trading.

NZ Dollar

This morning’s rate review by the Reserve Bank was more dovish than expected (see below) and the NZD reacted by falling about 0.6 cents to end this afternoon roughly where it was a week ago against the USD near 64.4 cents. Downside pressure also followed Fonterra cutting their forecast payout for this season from $4.60 to $4.15. But we are down near 1.5 cents against the AUD to a two month low of 91.6 cents as the AUD this week was boosted by slightly higher than expected inflation leading to reduced expectations of another rate cut by the RBA below 2%.

Our expectation and the RB desire is that the NZD fall further. But it pays to remember that at a time of renewed worries offshore we have some very good growth-supporting factors here in NZ which will lend strong support to our currency. Exporters should avoid getting over-optimistic about the NZD falling below US60 cents, and going below 90 Aussie cents for any length of time seems a brave call.
You will find current spot rates here. http://www.xe.com/currency/nzd-new-zealand-dollar

If I Were A Borrower What Would I Do?

I like our three year fixed rate at 4.49% so would take that if taking out a mortgage or facing a rate reset at the moment. It is possible that fixed rates go lower but not by much given that US monetary policy is tightening and rate moves there tend to influence fixed rates here. Having said that, in light of the turbulence on world financial markets since the start of the year markets in the United States have shifted from pricing in another four rate rises of 0.25% in the US this year to just one or two.

Similarly here in New Zealand expectations have risen of another easing of monetary policy to follow December’s 0.25% cut in the official cash rate to 2.5%. In making that decision the Reserve Bank wrote “We expect to achieve this (target range inflation) at current interest rate settings, although the Bank will reduce rates if circumstances warrant.”
That was changed this morning at the no change rate review to ...
“Some further policy easing may be required over the coming year to ensure that future average inflation settles near the middle of the target range.”
http://www.rbnz.govt.nz/news/2016/ocr-28-jan-2016.html

So if you like you might choose to sit floating waiting for lower fixed rates. But you will pay a price for doing so as floating rates are higher than all of our fixed rates. I see little chance of rates rising in the next couple of years so jumping into a fixed rate to avoid “missing out” is not really needed. But with fixed rates lower than floating it is simply a matter of when does one move to a good mid-term fixed rate. Personally, as already mentioned, I would fix three years now and stop worrying about trying to pick the bottom of the cycle. We have all proved we cannot do it.

For Noting

I came across an interesting piece of analysis regarding China this week. For years we have all been running on the expectation that for quite a few years more there would be an annual migration from the Chinese countryside into the cities of 10 – 15 million people and that the proportion of China's population classed as urban would rise substantially above the 50% hit about three years ago. However what the analysts have missed apparently is that many if not most of the people still considered "rural" have in fact become "urban" as they have shifted into newly built or expanded small cities (county towns) throughout the country. These towns, which one might in an NZ context consider akin to Kaitaia, have been ignored.

Including them means the proportion of the labour force considered as working on farms drops from around 40% to 20%, the flow of migrants into the big cities has ended, and the expected demand for iron and cement to build accommodation for these people does not exist. They have already been rehoused from country shacks into city apartments.

This helps explain why last year the official count of migrants in China's big cities fell 5.7 million to 246 million and why China has a massive over-supply of apartments running to the millions though no official number exists on its size. Suffice to say however that as a result of opening up all the spigots to fight the GFC, in the three year period from 2011 to 2013 China used more cement that the United States in all of the twentieth century!
http://www.ft.com/intl/cms/s/2/767495a0-e99b-11e4-b863-00144feab7de.html#axzz3yJFb3aPJ
http://www.bbc.com/news/world-asia-china-33802777
http://blogs.wsj.com/chinarealtime/2016/01/22/chinas-working-age-population-sees-biggest-ever-decline/

This mispredicting of future migrant flows means analysts have overestimated future (current) demand for the likes of iron ore and coal to make steel – hence price collapses. At least when it comes to forecast growth in demand for quality food products the dynamic is different as this is dependent upon income growth which is expected to remain firm.

But misforecasting the rural-urban growth bonus is only one negative factor in play for China. Others include huge debts for companies, banks and regional governments, too many factories and power plants, rising pollution and dissatisfaction about it, rising clampdowns on dissent, increasing blaming of foreigners, a falling currency, bleeding foreign currency reserves, a plummeting sharemarket, capital controls, and so on.

One cannot blame so many Chinese in recent years trying to get their funds out of the country. And even if they paid inflated prices for property elsewhere on the planet, each month that the Yuan falls in value they are better off – especially when it comes to the social status having offshore assets confers. Not that anyone makes a song and dance about such things these days with the government clamping down on corruption and leaving an implication that anyone with substantial assets offshore must have done something wrong back on the mainland.

China almost certainly will not have an economic collapse. But it does face potentially many years of uneven transition from an economy driven by exports, manufacturing and fixed asset investment toward one driven by consumption, and many years of working away at the debts built up by so many players. With Plan A faltering, watch for Plan B for keeping the populace willing to tolerate rule of the CCP – conflict against foreigners.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz